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FM AMEMBASSY ISLAMABAD  
TO RUEHC/SECSTATE WASHDC 4392  
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RUCPDOG/USDOC WASHDC  
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RUEHJI/AMCONSUL JEDDAH 2666

UNCLAS SECTION 01 OF 02 ISLAMABAD 000189

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E.O. 12958: N/A

TAGS: [EFIN](#) [ETRD](#) [ECON](#) [PREL](#) [EAID](#) [EINV](#) [PK](#)

SUBJECT: ISLAMIC FINANCE DEVELOPS SLOWLY IN PAKISTAN

¶1. (SBU) SUMMARY: Pakistan has started to develop well-managed financial products for Islamic banking and finance, but their market share is still low and will take time to grow. Currently there are six full fledged Islamic banks and 13 conventional banks that offer Islamic finance products at a total of 170 branches throughout Pakistan. Total assets of Islamic banks are close to USD 2.25 billion and Islamic banks control only about 2.2 percent of total bank assets. In the 1980s, Zia-ul-Haqq mandated Islamic principals for all financial institutions in Pakistan; however, the effort largely failed and was basically ignored by the financial services industry. Expansion of Islamic finance options is a long-term endeavor rather than a sudden boom. END SUMMARY.

Current State of Pakistan's Islamic Finance Industry

¶2. (U) Currently there are six full fledged Islamic banks and 13 conventional banks that offer Islamic finance products at a total of 170 branches throughout Pakistan, including Meezan Bank, Albaraka Bank, Dubai Islamic Bank, and Bank Islamic Pakistan. The State Bank of Pakistan (SBP) issued licenses to two additional Islamic banks, Emirate Global Islamic Bank, and First Dawood Islamic Bank.

¶3. (U) The market size is extremely small in Pakistan where total assets of Islamic banks are close to USD 2.25 billion and Islamic banks control about 2.2 percent of total bank assets in Pakistan, according to the SBP. Out of about five million borrowers countrywide, 23,000 borrowers have loans that conform to Islamic finance standards. Islamic banks offer about 75 percent of the financial products normally available at conventional banks such as checking accounts and loans, without the interest accumulation. These banks operate exclusively in larger cities, with the potential to expand to secondary cities, but are largely absent in rural areas.

¶4. (SBU) The Islamic banks are public limited companies and are

listed on the stock exchanges of Pakistan, according to Mr. Kamran Shahzad, the Executive Director of SBP. They are required to offer 50 percent of shares to general public. SBP says the GOP does not provide incentives for establishing Islamic banks. The SBP has a comprehensive strategy to increase market share of Islamic finance from the current three percent to 15 percent. No target date is indicated. To do this, the SBP says that the market would need to grow by 40-50 percent per year. As a part of the strategy, Pakistan intends to conform to standards promoted by the Islamic Financial Services Board (IFSB), a sixteen member council of governors and central banks. Pakistan assumed chairmanship of the IFSB in January 2008.

#### Islamic Finance and Banking Overview

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15. (SBU) Islamic finance did not begin in Pakistan until the 1980s, although Pakistanis proudly proclaim that the nation's founder, Muhammad Ali Jinnah, emphasized the virtues of its practice as far back as 1948. Developed in the Arab countries during the 1970s as a niche industry, modern Islamic finance and banking concepts are relatively recent developments. Today Islamic financial institutions are present in almost 60 countries, with Singapore widely considered the capital of the industry and London trailing second.

16. (SBU) In Pakistan, it took five years (from 1980-1985) and eight major public policy developments to pave the way for Islamic, non-interest based banking transactions. The Governor of SBP, Dr. Shamshad Akhtar, said in a September 2007 speech that the "premature

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and sudden conversion" of the banking system in Pakistan in the 1980s to Islamic finance made it difficult to implement modern Islamic finance products today. Akhtar claims that due to former dictator General Zia-ul-Haq's policies in the 1980s where he declared full Islamization of the financial sector, the banking sector reacted by substituting common industry terms such as "interest" with words that sounded more Sharia compliant rather than making actual institutional changes. The Pakistani Sharia Appellate Court repeatedly issued ultimatum orders to Islamize the system at various times, but that proved impossible. Akhtar said that one of the key lessons from experiences in the 1980s is that it is best for the industry to adopt Islamic finance in an evolutionary rather than a revolutionary process.

17. (U) While Islamic finance practices vary among countries and regions, there are three main characteristics that make it different from conventional finance. One, Islamic financial products do not use interest whether it is assessed or paid. Instead, the investments are "rented" out to a third party trustee who shares the profit or loss. Second, Islamic banking and financial products are governed by Sharia law. Sharia compliance varies among countries, but they are often governed by a national Shariat Board and require banks to have a Shariat Advisor. Third, there are limitations on the indebtedness of individuals and corporations. Many Shariat boards use a ratio to determine the limit on indebtedness which can affect investment decisions. Pakistan has its own Shariat Board that determines how practices are compliance with Islam.

18. (SBU) The legal and regulatory frameworks still require development before Islamic finance can be a globally competitive sector in the banking industry, commented Akhtar, as she laid out the groundwork in a December 9 speech. She also said that within Islamic banking there are still disagreements about how to carry out the practice. Islam's many variants among countries make Islamic finance different throughout the Muslim world. Each Sharia advisory board differs on its view of Islamic finance, making a consensus difficult and increasing transaction costs. Akhtar says that, "A flexible and simpler interpretation of the basic tenets at the level of Scholar would enhance public acceptability."

19. (SBU) In practice, many Pakistani banks adopt a loose interpretation of Islamic finance and use existing conventional finance structures as substitutes for Sharia requirements. Pervaiz Saeed, Head of the Islamic Banking Department at SBP, said that

Islamic financial institutions follow the same regulatory framework applied to conventional banks, for example, with anti-money laundering rules. There are also no differentiated rules on financial disclosure requirements and oversight structure for Islamic finance. The only difference is that these banks are required to show compliance with Islamic principles of banking, including no use of interest and indebtedness.

Comment

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¶10. (SBU) Despite growing interest in Islamic finance and banking in Pakistan, there is no data to show a sudden surge in increased usage. The best way to develop Islamic finance may be to create globally competitive products that are financially compliant worldwide. The international expansion of a few large Islamic banks may standardize products and practices across countries. Due to the high level of complexity for structuring and monitoring Islamic finance, its growth in Pakistan will likely be slow, despite growing consumer interest in the concept. END COMMENT

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